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## RESPONSE

### A Way Forward for Tax Law and Economics? A Response to Osofsky's "Frictions, Screening, and Tax Law Design"

DAVID GAMAGE†

Meaningful law and economics analysis of detailed tax rules is notoriously difficult.<sup>1</sup> At a high level of generality, there are expansive public finance and tax theory literatures that evaluate the overall structures of taxation. But scholars have had only limited success in connecting these theoretical literatures to the study of the actual detailed rules that occupy most of the time and energy of practicing tax lawyers and government officials.<sup>2</sup>

Osofsky's excellent new paper—*Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*—suggests a path toward a more useful law and economics analysis of detailed tax rules.<sup>3</sup> To begin with, Osofsky's paper makes an important contribution to the literature on tax frictions. Osofsky persuasively argues that tax frictions should be designed to incorporate screening concerns.<sup>4</sup> As Osofsky documents, the existing literature on the design of tax frictions has focused almost exclusively on the goal of

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1. Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 529-66 (2013).

2. *Id.* at 557-66.

3. Leigh Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, 61 BUFF. L. REV. 1059 (2013).

4. *Id.* at 1083-1119.

detering wasteful tax planning.<sup>5</sup> The literature has thus analyzed how frictions can be designed to balance the goal of deterring wasteful tax planning against the goal of not imposing costs on regular business transactions.<sup>6</sup> Yet the frictions literature has not sufficiently incorporated the implications of heterogeneity in taxpayers' proclivity toward tax planning.<sup>7</sup>

In contrast, as Osofsky also documents, the existing literature on screening primarily focuses on ways in which tax-system design can overcome the disincentives to work caused by taxing income.<sup>8</sup> Traditional optimal tax theory has largely been concerned with the problem of taxpayers working less in response to taxation.<sup>9</sup> Yet the recent empirical literature suggests that taxation has only small effects—if any—on reducing taxpayers' work effort.<sup>10</sup> Instead, the recent empirical literature suggests that taxpayers primarily respond to taxation through a variety of responses that we might collectively refer to as "tax planning" or "tax gaming."<sup>11</sup> Thus, as Osofsky convincingly argues, the greatest potential for utilizing screening mechanisms in taxation is likely in regard to tax planning and tax gaming transactions.<sup>12</sup>

Incorporating the analysis of screening mechanisms into the design of tax frictions, then, has the potential to improve the tax law's ability to deter wasteful tax planning while imposing lower costs on regular business transactions. The key here is to take advantage of the information tax frictions can reveal about heterogeneity in taxpayers' proclivity toward tax planning. Osofsky argues

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5. *Id.* at 1063-71.

6. *Id.* at 1074-75.

7. *See id.* at 1091.

8. *Id.* at 1077 & n. 61, 1084.

9. *Id.*

10. David Gamage, On Double-Distortion Arguments, Distribution Policy, and the Optimal Choice of Tax Instruments 30-39 (Sept. 25, 2013) (unpublished draft manuscript) (on file with author).

11. *Id.*

12. Osofsky, *supra* note 3, at 1118-19.

for a general principle that frictions should be designed so as to impose higher differential costs on “tax planners”<sup>13</sup>—on those taxpayers who have both greater “ability and desire to engage in tax planning.”<sup>14</sup> To the extent that frictions can be designed to impose differentially greater costs on tax planners, and lower costs on non-tax planners, the frictions should better deter the wasteful tax planning of the tax planners while imposing lower costs on the regular business activities of non-tax planners.<sup>15</sup>

Equally interesting, in my view, is that combining the methodologies of the tax screening and tax frictions literatures potentially offers a path toward a law and economics methodology capable of analyzing how detailed tax rules should be designed to account for distributional considerations. Alex Raskolnikov has recently elaborated some of the fundamental problems with applying law and economic methodologies to the study of detailed tax rules.<sup>16</sup> Perhaps the most fundamental of these problems is that tax law is inherently about distribution.<sup>17</sup>

A number of scholars have suggested that the rules for calculating tax bases should be designed to promote efficiency, with distributional concerns handled exclusively through the setting of tax rates.<sup>18</sup> However, as I argue at length in a recent work-in-progress, in light of evidence that real-world income and consumption taxes are subject to significant tax-gaming, it is important to consider distribution when designing the rules for calculating tax bases.<sup>19</sup>

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13. *Id.* at 1061.

14. *Id.* at 1086-87.

15. *Id.* at 1089-91.

16. Raskolnikov, *supra* note 1.

17. *Id.* at 544-45.

18. *E.g.*, David Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1655-59 (1999). Indeed, I have also made arguments along these lines in prior scholarship. See David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 74-78 (2011).

19. Gamage, *supra* note 10, at 76-78.

Osofsky's analysis suggests that tax rules might be designed so as to take account both of heterogeneity in taxpayers' tax planning proclivities and of taxpayer characteristics relevant for distribution. It is generally understood that the U.S. income tax is relatively successful at taxing the economic income of regular salaried employees, but much less successful at taxing the economic income of financiers and entrepreneurs and other taxpayers with great wealth.<sup>20</sup> By designing tax rules so as to create frictions that differentially impose higher costs on these taxpayers—who are more successfully circumventing existing taxes—we can perhaps reform our tax system so as to better achieve equitable distribution at lower efficiency costs.

As Osofsky concludes: "It is time to ask, in a rigorous way, how different groups of taxpayers are bearing [friction] costs differently, based on underlying characteristics, and how these differences should affect tax law design."<sup>21</sup> It is my hope that the coming decades will witness the development of a more refined tax law and economics methodology that is better suited to analyzing detailed tax rules. If so, Osofsky's paper will undoubtedly play an important part in the development of this (hopefully) forthcoming revolution in tax law and economics.

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20. See, e.g., David Gamage & Shruti Rana, *Taxation and Incentives in the Business Enterprise*, in ENTERPRISE LAW: CONTRACTS, MARKETS, AND LAWS IN THE US AND JAPAN (Zenichi Shishido ed., forthcoming 2014) (manuscript at 10-12) (on file with author); Douglas A. Shackelford, *The Tax Environment Facing the Wealthy*, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 114 (Joel B. Slemrod ed., 2000).

21. Osofsky, *supra* note 3, at 1119.